Testimony to the Montana House Appropriations Committee on HB 2

Montana Department of Revenue Budget

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I wish to thank Chairman Beck and the members of the General Government Subcommittee especially, Rep. McChesney and Edmunds, for their careful attention to our budget. We appreciate the highly professional and thoughtful manner in which the subcommittee conducted its work.

It is a privilege and honor to talk to you today about the budget of the Montana Department of Revenue. It is an honor because I believe that this department—which has long benefitted from a talented work force committed to excellence in public service—has transformed itself over the last six years into a high performing, efficient and effective organization that serves Montanans well. It has done so with the help of the Legislature and the support of the Governor.

The Montana Department of Revenue is responsible for more than $2.6 billion in state and local revenue each year. If the Department were a business, these revenues would be twice as large—as measured by Montana sales—as any other business operating in our state. We have more contact with more citizens and businesses than any other state agency. The product we produce—revenue—is the life blood of most of Montana state and local government. Yet, we are much smaller than several other state agencies in terms of the number of staff. Given the scope of our work, its importance to government services and our responsibilities to the public, this budget deserves careful consideration.

Over the last two years, we have set records for audit collections—and as a result this 2011 Legislature meets with $150 million more in the state treasury than would otherwise be the case—$150 million more that you can devote to the public purposes that you choose.

Over the last six years, we have gone from the bottom to the top rank of the states in our providing and Montanans using convenient and inexpensive electronic filing options. In 2010, 70% of Montana individual income taxpayers filed electronically. And last year our speed of paying refunds to individual income tax taxpayers was at an all-time high.

Our liquor control division has cut our cost of operations as a percentage of sales and increased our operating efficiency by 13% over the last six years. With the help of the Legislature approving a plan for strategic renovations, we have extended the life of the liquor warehouse by 25 or 30 years—saving taxpayers from a costly warehouse replacement in the next few years—and we have cut energy costs dramatically.

We completed in 2009 the most complex and extensive property reappraisal in history. According to the first time ever independent audit of our reappraisal results, we hit the bulls-eye in measuring the level of market prices for residential and commercial property as of the reappraisal date. We have protected taxpayers and local governments from a constitutional challenge to our property system by reappraising agricultural land on an objective, scientific basis for the first time in 46 years. Time and again we have successfully defended our property valuation of major facilities in the state—protecting homeowners, small businesses and farmers and ranchers from unfair tax increases and ensuring greater stability in local government and school district finances.

These are the highlights. We could discuss more. Suffice it to say that we are proud of what we have accomplished and eager as an agency to do even more—and we can if we are funded as recommended in the Executive Budget.

The product of the Department of Revenue is revenue properly collected for state and local government, fairness among taxpayers, economic growth and jobs based upon a level tax playing field among businesses, and public trust for the integrity of the law. Cutting the Department's budget by $6.1 million, as recommended by the subcommittee, does not make sense in these times. It does <u>not</u> save you money, its <u>costs</u> you $36 million in lost revenue because you will reduce the ability of the Department to collect revenues due and owing under the law. It does not help the vast majority of Montana taxpayers who pay the right amount of taxes on time year after year. Instead, it hurts honest Montanans by rewarding those who fail to file returns, who dishonestly underreport income, or who are delinquent and fail to pay their taxes. Cutting the Department's budget especially hurts Montana taxpayers by rewarding non-residents and out-of-state companies who neglect or ignore their tax responsibilities to Montana to a disturbingly greater degree than our citizens. Cutting our budget does not help the Montana economy, it hurts it in many ways. It limits the ability of this Legislature to implement policies that you believe are good for our economy. It allows businesses who underpay their taxes to gain an unfair advantage over the businesses that diligently meet their responsibilities—and in the process economic efficiency and growth suffer. It allows money that belongs here in Montana creating jobs for our citizens to escape our borders through out-of-staters who fail to pay the right amount of Montana taxes.

I would like to turn to the main issue: Cutting the budget of the Department of Revenue by $6 million will result in a loss of revenue of $36 million—six dollars of revenue lost for each dollar of budget cut. Whatever your definition of fiscal balance may be, cutting this budget gets you further away not closer to that balance. If you think there is a hole in the state budget, cutting the Revenue Department makes that hole bigger.

While you may have seen different numbers on the ratio of revenue dollars lost for each dollar of budget cuts—the fact that the loss of revenue is greater than the budget is a settled question. Both your legislative staff and executive branch officials agree on this specific point: cutting our budget cuts revenues by even more.

What is the basis for our six to one ratio? We begin with the fact that the Department of Revenue in FY 2010 was responsible for generating $48 of state and local revenue for each dollar expended. If you eliminated our $54 million budget for last year, the lost revenue would have been $2.6 billion dollars. That average return of 48 to 1 breaks out among three major department functions as follows: $39 generated for every dollar spent on property tax administration. $9 for every dollar spent on liquor administration and $72 for every dollar spent on state level tax collection. That is the average rate of return on the entire Department budget. We understand that no one is talking about eliminating the entire Department budget—but this average rate of return illustrates the link between the funding you provide Department activities and revenues collected.

The immediate question is not what would happen if you cut the entire budget, but what if you cut $6.1 million from the budget as proposed by the subcommittee? There are many ways to estimate the revenue that will be lost, but the best way is to look at verified data of what has happened when state tax agency budgets have been increased or decreased. We have examples of eight states in the last decade—including our own state—that increased their revenue agency budgets with the intention of improving revenue collections. The return on investment ranged from a low of 5.8 to 1 in New Mexico to 14.7 to 1 here in Montana. All except New Mexico exceeded a 6 to 1 return.

Let's look at the opposite cases. Three states intentionally cut their revenue agency budgets in recent years. These cuts resulted in <u>documented</u> revenue losses ranging from 5 to 15.4 times the amount of the cuts. The agency most like our Department in this group, the California income tax agency, lost 7.2 dollars in revenue for each dollar in budget cuts—and the revenue losses occurred quickly after the cuts occurred. We urge you not to repeat the mistakes made in these states.

Additional evidence comes from the even more recent experience next door in Idaho where their legislature last year funded a major increase in compliance efforts. As indicated in the news report in the materials we have provided, this legislative budget action is bringing in more than twice its revenue goal.

A third way to look at the potential return from investing in tax compliance is the backlog of case work we have in the Department. Nearly half of the non-filer cases we have identified in the last several years remain unworked—15,600 out of 31,900 cases remain unattended because of insufficient staff. The backlog is even greater for non-compliance cases. We have worked

42,000 cases generating $13 million. Unfortunately, we have 98,000 other cases that are untouched.

Based on the actual experience from several states, the new results from Idaho and our backlog of compliance work, a 6 to 1 ratio is very conservative. It is lower than the overwhelming majority of the documented impacts that have occurred from increases or decreases in state tax agency budgets around the nation—including previous experience right here in Montana.

Why is the 6 to 1 ratio higher than what you have heard from your staff? We respect your staff and their work. However, they left out two things from their analysis. They did not consider the impact of our budget in generating voluntary compliance revenues, and they excluded property taxes. I will focus for the next few minutes on these areas because they have not been sufficiently considered in the revenue impact analysis. However, these next remarks should not obscure the clear fact that our state audit and compliance work has been producing record results—the extra $150 million in the bank over the last two years that is now available to this Legislature. This $150 million was generated by our achieving a record level of audit productivity higher even than the conservative 6 to 1 return we urge you to use in making decisions on our overall budget.

Voluntary compliance revenue collections do not occur automatically without any effort. If we did not design effective forms and instructions—if we did not provide convenient electronic filing methods—if we did not answer taxpayer questions—if we did not open the mail and deposit the payments—if we did not pay refunds promptly or send notices of taxes due monthly, voluntary compliance revenues would fall dramatically. We know from Montana's own experience with the notorious failure of the POINTS computer system a decade ago that bad service results in lost revenue—over $20 million of lost revenue as documented by the Montana Legislature when it pulled the plug on POINTS in 2003. Budgets for taxpayer services affect voluntary compliance revenues—which is why revenue ratios are greater than 6 to 1 in almost all the states where tax agency budgets were increased or decreased.

The impact of the budget on property taxes obviously needs to be considered as well. Property taxes are a $1.25 billion business each year. Not a single dollar of property tax is collected each year except through the actions of the Department. In a sense, property taxes are equivalent to audit collections for state taxes. The property tax dollars are directly generated in proportion to the extent of Department efforts.

Each year from January into November the Department recreates the local property tax rolls and billing information. We inventory the changes in the local levy districts, gather personal property and centrally assessed information and assess values for that property, identify and value changes to real property, record changes of ownership, issue assessments, respond to appeals and then certify values to more than a thousand local governments and school districts.

Once budgets are set, we then gather local budget and mill levy information and create approximately a million individual property tax billing files to transfer to county treasurers who then process and send the individual bills to taxpayers. In between time we do physical surveys of property for the next appraisal cycle. And in January we start all over again.

The budget and staffing for property tax work has shrunk significantly over the last fifteen or more years while the number of parcels of property have increased substantially—without any major changes in technology to help manage the increased workload per person. We offer some examples—based on institutional memory—of the reduction in staff in eastern and north central Montana. In both cases our staff is about one-third less, while the amount of property parcels has increased. So we are stretched very thin in our property tax functions. A map of current staffing displays the distribution among the counties of our property tax staff.

Now the subcommittee's budget recommendation would cut almost $1 million annually or $2 million over the biennium from the property tax budget—which would require us to hold open 17 additional positions beyond the vacancy savings you otherwise require. Some subcommittee members asked us to establish priorities for budget cuts, so let's go through a decision process for where these 17 additional vacancies would occur. We could start by eliminating our central property office in Helena which has a few more than 17 staff members. Because this is the nerve center that controls the information flow for the entire property tax system, eliminating the central office would risk losing all $1.25 billion in <u>annual</u> property collections in Montana and bring all local governments and schools in Montana to a halt. If the worst case occurred, that is a revenue loss of $1,250 for each dollar of budget savings. The risks under this option are not acceptable. Or we could just eliminate the property tax function in one county—let's say Cascade County with its 18 positions. That would fit with the proposed budget cut, but it would eliminate $82 million in annual property tax revenue and also eliminate all local government functions and schools in Cascade County. That is an 82 to 1 loss. Great Falls and surrounding communities would probably not consider that a reasonable option, nor would we. So we could instead shut down operations in the twelve smallest counties. $33 million of annual property tax dollars—or 33 times the budget savings—would be lost, and local governments and schools would be eliminated in these counties. That's not reasonable either.

So what would we actually choose to do under the subcommittee recommendations? 17 positions would be held vacant in the largest 12 counties with current staffing from 6 to 29 staff members each—because that's where the property tax positions mostly are. One function that would cease in these counties would be the annual identification of new construction. Only about 20% to 30% of new construction would be picked up each year through the cyclical reappraisal reviews. The revenue loss under the 101 state mills for the state general and University funds would be between $7 and $8 million a year. At the local level, assuming that property taxes would be shifted through mill levy increases, 70% to 80% of new construction in a given year would be tax free and between $30 and $40 million in local property taxes would be unfairly shifted to existing property owners. The loss in <u>state</u> revenue—not counting the disruption to schools, counties and cities—would about $7 to $8 for each dollar in the property tax budget cut. That is slightly more than the general 6 to 1 ratio we use to project the overall $36 million loss in state revenues from the subcommittee recommendations. So the least damaging option still loses several times the revenue compared to budget savings—and produces inequities in the distribution of property taxes.

This property tax exercise is a good illustration—but only one illustration—of what happens to the entire state and local tax system when the Revenue Department's budget is cut. We could go through similar examples for every other part of the Department—all of which are affected by the subcommittee's recommendations. Each part of the Department affects our ability to produce our results—and most of the parts interact and affect each other. How the parts of the Department work together, how we measure our results and produce continuous improvements in productivity and results for our citizens is explained in the final paper in the materials we have provided to you. I would call your attention in particular to pages 11 and 12 of that paper that displays our record state level audit collections and audit productivity.

Mr. Chairman I am not going to address in detail certain technical subcommittee recommendations that we hope this committee will reconsider. In addition to amendments restoring $6.1 million to the Department's budget, there are amendments to remove restrictions that limit our efficiency and effectiveness. Those restrictions that we would ask to be removed include one time designations and the absence of FTE authority to match personnel funding.

There are no areas of the Department where a reduction in the budget would not result in a reduction of revenues for state and local governments. You lose six or more times the revenue than you save in expenditures. Taxes end up being unfair. For property taxes, existing property owners lose, and owners of new construction win. At the state level, honest taxpayers lose out to the dishonest and the delinquent. Montanans lose as compared to non-residents and out-of-state companies. Diligent and honest businesses that pay the right amount of taxes face unfair competition from and lose capital to those businesses that help themselves to illegal tax subsidies by underpaying taxes. The result is a misallocation of capital that reduces economic efficiency and the growth of jobs in Montana. So it does not make sense in terms of sound state fiscal policy, tax fairness or good economic policy to cut the Department of Revenue budget. **Our work pays for itself several times over in better revenue collections, supports a stronger economy and creates greater trust of our citizens in the fairness and integrity of our tax system.** We urge you to restore through all the prepared amendments the Department of Revenue's budget to the Executive Budget levels—and in so doing restore $36 million to the revenue estimates—for a net gain in fiscal balance of $30 million for the citizens of Montana.